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¶1. (U) Provided below is Embassy Buenos Aires' Economic and Financial Review covering the period May 6 - 23, 2008. The unclassified email version of this report includes tables and charts tracking Argentine economic developments. Contact Econoff Chris Landberg at landbergca@state.gov to be included on the email distribution list. This document is sensitive but unclassified. It should not be disseminated outside of USG channels or in any public forum without the written concurrence of the originator. It should not be posted on the internet.

Highlights

-- Capital flight accelerates due to increasing political uncertainty
-- Who are the "Holdouts"?
-- Debate over poverty statistics
-- INDEC seminar and announcement of new CPI
-- FIEL raises concerns about taxes, expenditures, revenues, and salaries

Capital flight accelerates in first quarter due to increasing political uncertainty
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¶2. (SBU) Capital flows out of Argentina's financial system (by the non-financial private sector) reached $2.2 billion in the first quarter of 2008, according to the BCRA's quarterly foreign exchange report (published April 25). Following a neutral balance in the first quarter of 2007, there is a clear trend in the non-financial private sector towards taking hard currency out of the financial system, with outflows of $5.2 billion in QIII 2007 and $3.4 billion in QIV ¶2007. Capital outflows have been more than compensated for by the strong trade surplus, which reached a record $4.0 billion in QI 2008, compared to a $3.3 billion surplus in QI ¶2007. Embassy banking sector contacts confirm that the tendency so far in 2008 in both the retail market and with companies is to dollarize peso portfolios.

¶3. (SBU) The move into dollars is partly a reaction to the Ag sector conflict, which began March 11 when the GoA imposed a sliding scale export tax on agriculture exports, and it has been exacerbated by the GoA and Ag sector's apparent inability to resolve it. However, Post's banking sector contacts emphasize that the mini-run on the peso began in early March, with the recognition that inflation was accelerating. The combination of high and accelerating inflation and the continuing strike is stoking rumors and fears of a peso devaluation. The Ag strike also aggravated the deteriorating situation in the FX market, since lower Ag commodity exports reduced the supply (inflow) of hard

currency at the same time that demand was increasing. (Ag exports, mainly wheat, corn and soy and soy sub-products, provide 35% of the dollar supply from exports.)

¶4. (SBU) Highlights of the Foreign Exchange Balance report:

-- A surplus of $3.6 billion for the current account of the Foreign Exchange Market for the first quarter, compared to $2.6 billion the same period last year. (This is the net inflow of FX from all trade transactions, including merchandise, services, and investment income.);

-- A deficit of $96 million for the capital account in QI 2008, compared to a surplus of $2 billion in QI 2007. The deficit in the capital account was generated by the $2.2 billion capital outflow from the non-financial private sector, which was partially compensated by $1.2 billion inflows from foreign direct investments (mainly for oil, agriculture, car, steel and mining sector) and $720 million inflows from loans and credit lines to the private sector.

-- BCRA reserves reached a record of $50.6 billion at the end of QI as a result of the BCRA net purchases of foreign exchange of $2.6 billion.

-- In order to pay foreign currency debts, the Treasury purchased $1.5 billion in QI 2008, compared to $619 million in QI 2006 and $400 million in QI 2007.

-- (Note: the Foreign Exchange Balance (FEB) and the Balance of Payments (BOP) report have a similar format. However, the former reports purchase and sales of foreign currency without

considering the residency of the parties, while the latter reports economic transactions focusing on the residency of the intervening parties. Also, the FEB uses a cash-basis methodology, while the BOP uses accrual accounting.)

¶5. (SBU) So far in the second quarter, the unresolved Ag conflict, accelerating inflation, and the President's plummeting approval rating have increased the level of pessimism about the future of the Argentine economy, spurring greater dollar outflows. However, the BCRA's heavy interventions in May, selling dollars in both the spot and futures markets, succeeded in bringing the nominal exchange rate down to a trading range of 3.14-3.16 ARP/USD (wholesale) by May 23. This proved to the market that for the time being the BCRA has sufficient firepower to keep the exchange rate at whatever level it desires. Due to the 7-10 delay in the release of BCRA data, it is still unclear how deep the BCRA has had to dip into reserves to date, but as of May 16 the BCRA had sold $1.2 billion, and reserves had fallen to $49.1 billion, below the psychologically important $50 billion level.

Who are the "Holdouts"?

¶6. (SBU) There has been a lot of reporting about the so-called "holdouts" -- holders of GoA defaulted debt not tendered in the 2005 GoA debt restructuring -- but not much is known about who they are. Determining who holds the $28.8 billion amount outstanding (as of December 2007, according to GoA debt statistics) -- and roughly $3 billion held by U.S. investors -- is more art than science, since defaulted debt is still being traded (currently at about 32-34 cents). However, it is possible to identify those holdouts that have engaged in legal actions to recover the whole value of their defaulted bonds. These holdout bondholders cannot sell the bonds as they need to show ownership of the bonds when going forward with legal proceedings.

¶7. (SBU) Holdouts have not succeeded in their efforts to recover investments, but they have caused major difficulties for both the GoA and BCRA: 1) holdout lawsuits delayed the 2005 GoA settlement by almost three months; 2) $105 million

of BCRA reserves held at the Federal Reserve Bank of New York (FRBNY) are frozen on account of a holdout lawsuit; 3) a recent holdout lawsuit resulted in the freezing of $2 billion of Global bonds held at the Depository Trust Company (DTC) and backing Guaranteed Loans (GLs); this lawsuit has effectively blocked the GoA's plan to conduct a debt swap of the GLs and smooth out the 2009-2011 debt amortization schedule (see May 5 Econ/Fin report); 4) the GoA must resort to complex legal structures every time it makes an off-shore payment; and 5) the threat of holdout lawsuits has virtually eliminated the GoA's ability to raise fund through bond issuances under international law, raising financing costs by an estimate 50 to 100 basis points.

¶8. (SBU) Based on a detailed analysis of the public information available in Lexis-Nexus database:

-- There are 70 bondholder cases filed against the GoA in U.S. courts, all of which are in the court of Judge Thomas Griesa, U.S. District Court for the Southern District of New York.

-- These 70 cases are claiming a total face value of almost $2 billion, without considering past due interest, penalties, or other compensation for delay in payment.

-- Many of the cases where filed by multiple bondholders (including both physical persons and companies), so the total number of investors involved exceeds 70.

-- The average claim is almost $30 million. The smallest claim is for $133,000, whereas the largest is for $595 million. Only five cases comprise almost 70% (or $1.3 billion) of the total claimed. These five plaintiffs are: EM Ltd, Greylock, GMO, NML Ltd, and BNP Paribas. These plaintiffs (and their lawyers) are also the most vocal of all outstanding U.S. holdouts.

-- In two out of the 70 cases, the lawsuits are against both the GoA and the Province of Buenos Aires.

-- The status of most of the cases is that the Judge granted the plaintiff motion for summary judgment. (Note: There are possibly many other cases in the pipeline, for which a Judge has not issued a ruling. It is also possible that some of

the 70 cases have had partial advances -- such as beginning the assets discovery process, in order to identify attachable GoA assets -- but Judge Griesa has not made a final public ruling.)

¶9. (SBU) Economy Ministry contacts confirmed the freeze on BCRA reserves is still in place. The two plaintiffs in this case are E.M. Ltd, covering defaulted bonds with a face value of $595 million, and NML Ltd, with a face value of $142 million. The plaintiffs argued for attaching the BCRA's $105 million reserves held in its FRBNY account, following two GoA decrees allowed the use of BCRA funds for repayment of Argentina's debt to the IMF. The plaintiffs and the GoA are currently debating the definition of reserves and whether BCRA reserves have been used for commercial purposes (as defined under the Foreign Sovereign Immunities Act of 1976) and are, consequently, attachable. (The USG submitted a Statement of Interest in 2004 and an Amicus Curiae brief in 2006, related to the attempts to attach BCRA assets.)

¶10. (SBU) ICSID Holdout cases: Apart from cases filed in U.S. Courts, other investors (mainly Italian) have filed two claims before the World Bank's International Centre for Settlement of Investment Disputes (ICSID). According to the ICSID website:

-- The first case was filed under the name Giovanna a Beccara in February 2007, and ICSID accepted the case and constituted a "Tribunal" in February 2008;

-- The second case was filed under the name Giovanna Alemanni in March 2007, and ICSID has not yet constituted a Tribunal. ICSID has not released details on the amounts involved. However, according to Argentine media, the first case was filed by Task Force Argentina (TFA), a bondholder group that claims to represents 195,000 Italian bondholders holding about $4.4 billion (face value) of GoA defaulted bonds. (Note: The majority of the Italian bondholders are retirees who lost significant portions of their savings in the December 2001 default.)

Debate over poverty statistics

¶11. (SBU) President Cristina Fernandez de Kirchner (CFK) announced May 12 a decline in Argentine poverty levels to the 20.7% level, down from roughly 23% in late 2007 and down 33 percentage points from its post-crisis peak of 54% in 2003. CFK said this drop should be a source of national pride for all Argentines. Her statements provoked a passionate debate over the real level of poverty in the country, with many analysts arguing that poverty is expanding rather than declining.

¶12. (SBU) Many independent economists put current poverty levels at a significantly higher 30%, and estimate that poverty rolls increased by 1.3 million citizens in 2007 alone. These economists blame rising inflation -- particularly increases in the costs of food and basic services -- for the increasing poverty. They attribute the substantial difference in independent vs. GoA poverty measures to the GoA's manipulation of inflation statistics since February 2007. Local analysts predict that the political fallout on the CFK government of this rise in poverty will be significant. They argue that this is the reason why the Kirchners have in recent weeks switched from denying that inflation is a serious problem to blaming it on the "socially irresponsible" striking rural agricultural sector.

INDEC seminar and announcement of new CPI

¶13. (SBU) Argentina's National Statistics Agency (INDEC) hosted an international seminar on the CPI May 7 on "International Experiences with the CPI: Certainties and Challenges." INDEC invited experts from Spain and France, as well as Walter Lane, Chief of the Branch of Consumer Prices in the Office of Prices and Living Conditions at the U.S. Bureau of Labor Statistics. Lane and other foreign representatives participated during the first session, focusing mainly on methodological aspects of the CPI. INDEC staff members and union leaders also spoke during the first session, all making the same call for a CPI that supports the "local economic model for development" (meaning, growth with income redistribution). INDEC used the second session to announce features of the new Argentine CPI:

-- INDEC will frequently rebalance products in the new CPI,

and criteria for rebalancing will be based on: i) seasonality; ii) points of sales; iii) quality changes; and iv) patterns of consumption. (Comment: This turns the CPI into a cost-of-living index, rather than a means to measure inflation; this will not facilitate private indexation decisions, such as salary increases.)

-- The new CPI will only cover the second and third quintiles of the income distribution (lower-middle-class), which means that the CPI will be biased to lower income patterns of consumption (and will, therefore, under-weight areas of high recent price increases, e.g., private schools, private medicine).

-- INDEC will incorporate consistency analysis and data filtering, to avoid the inclusion of outliers.

-- The new index will see a reduction in the number of varieties included.

¶14. (SBU) In a private note for clients, HSBC analysts pointed out that bondholders should keep in mind that this new methodology will consistently result in lower consumer price inflation than the methodology used prior to 2007, even with the same inputs. These analysts say it is impossible to know at this stage how much lower inflation will be, and that it will depend on the government commitment to a credible index. Their base scenario is that the new index will report around 8% - 9% annual inflation until further evidence is available. The fact that the government is institutionalizing a method that reports lower inflation than a conventional CPI is bad news for the bond market, though markets have most likely fully priced this news into current prices.

FIEL raises concerns about taxes, expenditures, quality of revenues, and salaries
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¶15. (SBU) Renowned Buenos Aires-based Latin American Economic Foundation -- FIEL -- raised the following concerns during a May 21 Seminar. (FIEL is a highly regarded, independent Argentine think-tank devoted to economic and social research on Argentina and Latin America.)

-- Argentina's fiscal burden is much higher than in the past. It has increased in each of the last six years, and is currently at about 33% of GDP when including federal, provincial, and municipal taxes. This is higher than during the 1990s, when it averaged 21-22%, and much higher than during the 1980s, when it was below 20%. Argentina's fiscal burden is now comparable to Brazil's, which is the highest in the region (followed by Uruguay at 30%). The agricultural sector conflict is the first tax rebellion, and FIEL believes others could follow.

-- GoA expenditures: April primary expenditure increased 52% y-o-y, compared to an increase of 38% y-o-y for the first quarter. However, FIEL argues that the GoA under-reported March's expenditures. In order to reduce the average of the quarter, the GoA pushed forward some expenditures due in March to April. In this way, the GoA avoiding showing a low primary fiscal surplus in March, since March revenues were weak. Elasticity of expenditures: per every increase of 1% of GDP in expenditures, the primary surplus falls 0.9% of GDP.

-- GoA Revenues- extra help from BCRA: In March and April, the BCRA transferred earnings of ARP 1.4 billion (the total budgeted for the year) to the GoA, which helped improve the GoA's reported revenues and primary fiscal surplus for the first quarter. The BCRA transferred ARP 1 billion in March and the remaining ARP 400 million in April.

-- Salaries: March 2008 formal-sector salaries measured in dollar terms (considering only salaries and not other benefits) are higher in nominal terms than salaries from October 2001 for many sectors of the economy. However, when including benefits and the salary increases granted in negotiations so far this year, 2008 salaries in dollars are higher in nominal terms than the ones from 2001 for all sectors. (2008 salaries are still lower in real terms than equivalent salaries in 2001.)

-- Increase in Argentine risk (as measured by the JPMorgan EMBI plus) to record levels indicates concerns over the GoA's willingness to pay, not concerns over its capacity to pay. Data Manipulation: FIEL strongly believes the GoA is

manipulating the EMAE (monthly economic activity index) and GDP, in addition to the CPI (which was severely manipulated in March, particularly for food items).

-- Devaluation expectations: with true inflation somewhere between 20-30% and nominal peso devaluation of 1.5-2% per year, the GoA model of maintaining industrial competitiveness through an undervalued currency does not seem to be sustainable. This is what is driving market expectations that the GoA will eventually devalue the peso.

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